

**Franchise Tax Board****ANALYSIS OF ORIGINAL BILL**

Author: Solorio Analyst: John Pavalasky Bill Number: AB 315  
Related Bills: None Telephone: 845-4335 Introduced Date: February 9, 2011  
Attorney: Patrick Kusiak Sponsor: Author

**SUBJECT:** Nonadmitted Insurance/Surplus Line Brokers/BOE & FTB With Approval Of DOF  
May Become Party To Reciprocal Surplus Line Premium Tax Compact Or  
Agreement

**SUMMARY**

This bill would forestall preemption on July 21, 2011, of state statutes pertaining to surplus line insurance taxation, eligibility, and broker licensure by the Nonadmitted and Reinsurance Reform Act (NRRA) of 2010 (Subtitle B of Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203, July 21, 2010)).

**RECOMMENDATION AND SUPPORTING ARGUMENTS**

No position.

**Summary of Suggested Amendments**

A technical amendment is needed to Revenue and Taxation Code section 13210(b) and is provided.

**PURPOSE OF THE BILL**

According to the author's office, the purpose of this bill is to make California law compatible with new federal law.

**EFFECTIVE/OPERATIVE DATE**

This is an urgency bill and would go into effect immediately; however, specified provisions in the bill would become operative on July 21, 2011.

**ANALYSIS**FEDERAL/STATE LAWFederal Mandate

The NRRA reforms and modernizes two important sectors of the commercial insurance marketplace, nonadmitted insurance (also known as 'surplus lines' insurance) and reinsurance. Specifically, the NRRA makes various changes to the business of surplus lines insurance including:

Board Position:

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Department Director

Date

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- Exclusive home state of the insured regulation of surplus lines insurance placements;
- Exclusive home state of the insured surplus lines broker license requirements;
- Exclusive home state of the insured premium tax collection unless a state compacts with other states on a method of allocation of taxes on multistate policy risks; and
- Preemption of many state specific eligibility requirements for surplus lines insurers.

Thus, the NRRRA creates a uniform system for nonadmitted insurance premium tax payments based upon the home state of the policyholder, encourages the states to develop a compact or other procedural mechanism for uniform tax allocation, and establishes regulatory deference for the home state of the insured. The NRRRA adopts uniform eligibility requirements for nonadmitted insurers as developed and promulgated by the National Association of Insurance Commissioners (NAIC) in the Nonadmitted Insurance Model Act. The NRRRA also allows direct access to the nonadmitted insurance markets for certain sophisticated commercial purchasers. The NRRRA could be viewed as preempting state law that is incompatible with it.

A simplified example of a surplus lines multistate transaction is a business entity headquartered in one state with offices in other states seeking insurance coverage for all offices. Under the NRRRA, the state in which the business is headquartered would be the home state and placement of the insurance business is subject only to the statutory and regulatory requirements of this state, as is the collection of the premium taxes. A state in which the business has another office must have the statutory authority to participate in a tax-sharing agreement or compact in order for it to receive its apportioned amount of the tax. Absent this authority, the tax monies go only to the home state of the insured.

Most provisions of the NRRRA go into effect on July 21, 2011. However, provisions of a compact or agreement adopted on or before June 16, 2011, apply with respect to premiums for multistate transactions paid on or after July 21, 2010. A compact or agreement adopted after that date would apply with respect to premiums for multistate transactions paid on or after January 1, 2012.

### Current California Law

A surplus lines insurer, also referred to as a nonadmitted insurer, is not licensed in California, but is licensed in another state or country. Under current state law, California licensed surplus line brokers may place coverage with a nonadmitted insurer if insurance for the risk is not available from a California-licensed insurer and other specified criteria are satisfied. Surplus lines premium tax imposed on the insured is collected by the Department of Insurance (CDI) from the broker placing the coverage, and the revenue is transferred to the Board of Equalization (BOE) for deposit into the state's General Fund.

In addition, policyholders who directly purchase or renew an insurance contract during the calendar quarter from an insurance company that is not authorized to transact business in California must pay a "nonadmitted insurance tax" (NIT). The tax is 3 percent on all premiums paid or to be paid to nonadmitted insurers on contracts covering risks located in California, and is imposed on any corporation, partnership, limited liability company, individual society, association, organization, governmental or quasi-governmental entity, joint-stock company, estate or trust, receiver, trustee, assignee, referee, or any other person acting in a fiduciary capacity.

Policyholders subject to the NIT must file Form 570, Nonadmitted Insurance Tax Return, with the Franchise Tax Board (FTB) on or before the first day of the third month following the close of any calendar quarter during which a nonadmitted insurance contract took effect or was renewed.

Not all contracts with nonadmitted companies are subject to the NIT. Nonadmitted insurance that is obtained through a California insurance broker is not taxable to the purchaser. Other exceptions are: (1) reinsurance of the liability of an admitted insurer; (2) insurance of ship-owner interests; (3) aircraft insurance; (4) insurance on interstate motor transit operations; and (5) life insurance.

**Section 3.5 of Article III of the California Constitution** prohibits an administrative agency, such as the CDI, BOE, or FTB, from declaring a statute invalid or unenforceable in the absence of an appellate court determination that the statute is unenforceable or unconstitutional. Therefore, unless the statute is amended, these departments will be required to continue to enforce current law unless an appellate court rules otherwise.

### THIS BILL

Specifically, this bill would:

- Authorize the collection of tax on 100 percent of California home state insured policies;
- Provide a common definition of home state insured, including principal place of business and principal residence;
- Provide enabling authority to enter into a compact or certain agreements;
- Permit the charging and collection of different premium tax rates for other states should California participate in a compact or certain agreements;
- Provide for changes in timing to tax payments as may be required by a compact or certain agreements;
- Conform surplus line eligibility standards to new federal preemption limitations;
- Provide for a permissive list of approved surplus line insurers that meet California's current, higher standards for eligibility;
- Conform surplus line broker licensing provisions to new federal preemption limitations; and
- Make other related changes.

### TECHNICAL CONSIDERATIONS

To be consistent with the changes to Insurance Code section 1775.5(b) regarding the collection of tax on 100 percent of California home state insured policies for those placed through brokers, the same changes need to be made to Revenue and Taxation Code section 13210(b) regarding insurance placed directly with nonadmitted insurers by the home state insured, as follows:

On page 66, strikeout lines 22 through 30, inclusive, and insert:

shall be the entire premium charged on all nonadmitted insurance for the California home state insured as defined by subdivision (f) of Section 1760.1 of the Insurance Code

## **PROGRAM BACKGROUND**

The NIT program administered by FTB is not an income tax program. The program was enacted by SB 625 in the 1993/1994 fiscal year and the revenue to the California Department of Insurance was estimated to be \$10-11 million annually at that time. The bill appropriated \$391,000 to cover FTB first year's administrative costs. At that time, according to the Surplus Line Brokers Association, 34 states levy a tax on non-admitted direct placement insurance. It was believed that only a few hundred insureds would be involved, and FTB would be able to administer the tax using a fairly simple manual processing method, using quarterly prepayments and an annual, reconciling return.

Currently the NIT program manually processes nearly 800 NIT returns per year and collects, on average, \$10 million in NIT per year. This is substantially more than the few hundred insureds originally estimated. There is no "information technology" (IT) system in place. Slightly less than 19 percent indicated risk located outside of California. Half of the 19 percent reported an address outside of California.

## **OTHER STATES' INFORMATION**

As of March 1, 2011, there is no compact in place. The two competing compacts are Non-Admitted Insurance Multi-State Agreement (NIMA), which is supported by the National Association of Insurance Commissioners (NAIC), and Surplus Line Multi-State Compliance Compact Lite (SLIMPACT-Lite), which is supported by industry.

Based on information received by the CDI from the NAIC, the current status of state's implementing the NIRA is as follows:

- South Dakota has enacted a bill, HB 1030.
- About 15 states have NIMA-related legislation pending.
- Eight to ten states have introduced or will soon introduce SLIMPACT related bills.
- About 20 states are actively considering NIMA.
- About three or four states will seek to make changes to conform their statutes to the NIRA, but they will not seek authority to join either NIMA or SLIMPACT.

## **FISCAL IMPACT**

The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

## **ECONOMIC IMPACT**

### Revenue Estimate

Recent federal legislation creates a uniform system for nonadmitted insurance premium tax payments and encourages states to create a compact or certain agreements for allocating taxes between states. This bill would enable California to enter into a compact or agreement, which must be entered into by June 16, 2011. Any revenue implications for California are dependent on the apportioning rules set forth in the compact or agreement and not this bill. It is anticipated that by entering into the compact or agreement California will continue to collect current NIT levels, but there is the possibility that California may collect more or less revenue, which is dependent on the details of the compact or agreement.

Currently, FTB collects, on average, \$10 million in NIT per year. If this bill does not pass and California does not enter into the compact, FTB will be forced to continue to administer the current non-admitted insurance tax program until a court decides otherwise.

## **SUPPORT/OPPOSITION**

Support: None at this time.

Opposition: None at this time.

## **ARGUMENTS**

Pro: California must enter into a compact or certain agreements by June 16, 2011, or lose the ability to collect surplus lines premium tax on multistate transactions for calendar year 2011.

Con: As of March 1, 2011, there is no compact or other agreement in place. The two competing compacts are NIMA, which is supported by the NAIC, and SLIMPACT-Lite, which is supported by industry. It is arguable whether having individual states choosing different compacts or agreements will provide the uniformity required by the NRRA.

## **POLICY CONCERNS**

The author may wish to consolidate the collection of the directly acquired insurance subject to the NIT with the collection by the CDI for insurance placed by surplus line brokers. This would provide a single agency responsible for the collection of gross premiums tax and thereby increase efficiency and uniformity.

## **LEGISLATIVE STAFF CONTACT**

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